

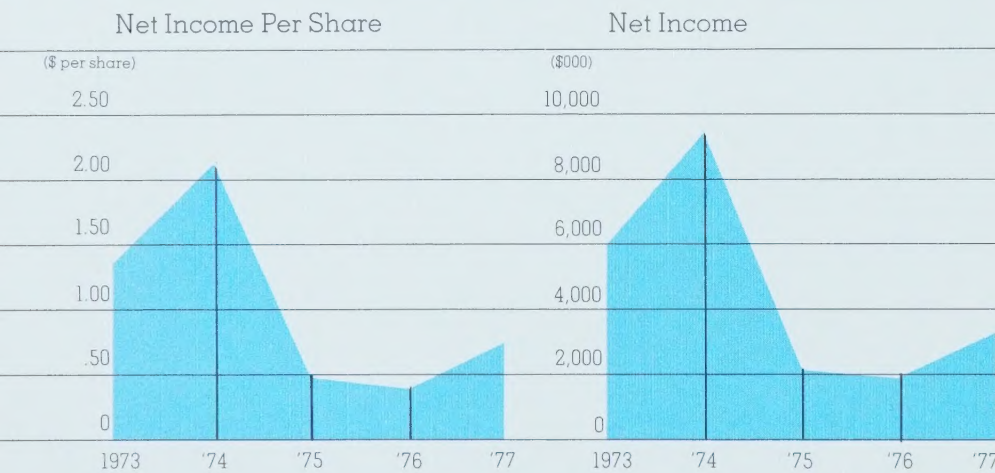
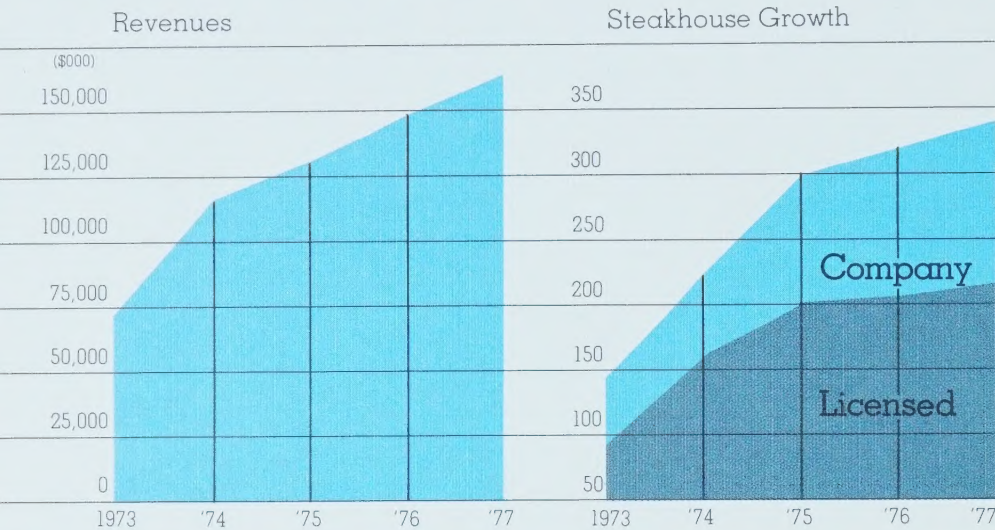
AR36

PONDEROSA SYSTEM, INC.
ANNUAL REPORT 1977

CONNECTICUT Danbury Groton Hartford New Britain Waterbury Southington Windsor FLORIDA Altamonte Springs Bradenton Clearwater Daytona Beach
Savannah Valdosta ILLINOIS Belleville Bloomington Bradley Carbondale Champaign Chicago (29) Danville Decatur DeKalb Elgin Fairview Hts. Grant
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Allentown Avalon Brookhaven Camp Hill Chambersburg Conshohocken Dixon Erie Harrisburg Lancaster Lebanon Lower Burrell Meadville Monaca
Uniontown Washington Whitehall York (2) RHODE ISLAND Cranston Johnston Woonsocket North Providence TENNESSEE Chattanooga Knoxville (2) Kingsport
Richmond (2) Springfield Virginia Beach WEST VIRGINIA Beckley Bluefield Charleston Huntington Parkersburg St. Albans WISCONSIN Appleton Beloit
Sheboygan Superior Waukesha CANADA-ALBERTA Calgary (4) Edmonton (4) Lethbridge CANADA-MANITOBA Brandon Winnipeg (3) CANADA-NEW BRUNSWICK
Corner Brampton Brantford Cambridge Chatham Cornwell Guelph Hamilton Kingston Kitchner (2) London (3) Niagara Falls North Bay Oshawa Ottawa (5) Peterborough
CANADA-PRINCE EDWARD ISLAND Charlottetown CANADA-QUEBEC Chateauquay Dollards Ormeaux Grandby Greenfield Park Hull Kirkland Montreal

For The Year Ended February 24, 1977

President's Message



The fiscal year ended February 24, 1977 was a very positive one for your company. Revenues were \$163,494,000, up 10% over the previous year. Net income was \$3,267,000, up 58%. In addition, \$5,000,000 of bank debt was paid down and \$10,315,000 in capital expenditures were funded internally. However, most encouraging was the performance during the fourth quarter, in which revenues were up 8%, and pre-tax operating income was \$1,329,000, or plus 411%. (This increase was computed before last year's fourth quarter pre-tax writeoff of \$3,550,000.) These fourth quarter results were attained despite some of the most severe weather in recorded history and materialized due to the implementation of the new programs which we have described to you in previous reports. The programs include the introduction of salad bars and seafood in all company units during the fourth quarter and the remodeling of an additional 93 company units during the year.

While salad bars are quite common in the restaurant industry, we believe that our salad bar is particularly responsive to our customers' desires. We expended, necessarily, a great deal of time developing it, and the training and operational programs to support it. Our objective was and continues to be, to ensure that the products contained in the salad bar are of the highest quality and that the maintenance and servicing of the salad

bar are of the highest standards, as well. The seafood program is basically comprised of three entrees: shrimp, fish fillet and the shrimp and steak platter. These items are a logical alternative to the all-beef menu and have been received very well by our customers. Again, much effort was spent not only developing the product but also the operational and training support. The remodeling program was announced almost two years ago and has been moving along smoothly. Presently, we have 136 company and 73 licensed steakhouses upgraded to our more private and comfortable decor. Our current plans call for a minimum of 60 company units to be remodeled this year with a large number of licensee units being remodeled as well.

During the year three new licenses were granted and 24 company and 14 licensed steakhouses were opened. With the closing of 4 company and 4 licensed restaurants, a total of 342 company and 219 licensed steakhouses were in operation at year end. Our plans this coming year call for approximately 24 steakhouses to be opened, of which 20 will be licensee operated. The modest development of company units this year is designed to permit us to continue the upgrading of our units and concentrate on improving the sales of existing steakhouses. There is great profit potential in our existing units and as this is realized, an increase in the development of new company units will take place.

Other items of significance occurred during the year. Perhaps the most important in the long term was the restructuring of the company into four operating divisions. These include two Steakhouse Divisions, one of which includes Scotty's; ESI, our meat processing operation; and our Licensing Division. These groups are headed by E. S. Weber, Jr., Executive Vice President—Eastern Division; D. D. Darbyshire, Executive Vice President—Western Division; C. M. Campbell, Vice President—Licensing Division; and R. F. Wolf, President—ESI Meats, Inc. We believe that this reorganization and the decentralization accompanying it will produce greater responsiveness to consumer needs at the local level. In conjunction with this, an incentive opportunity program was established for operating personnel through the executive manager level of each steakhouse which is based upon the attainment of defined profit targets. In addition, a separate staff group, Corporate Development directed by C. S. Lewis, was established which is devoted to corporate planning and concept & product development.

During the year, we revised our revolving credit agreement which was to convert to a term loan in February, 1977. The amount of our new revolving credit agreement is \$14,500,000 versus the \$20,000,000 previously, reflecting our improved cash management, and the resulting reduced credit needs. As you will note in our balance sheet, year end bank debt was \$11,500,000. I am pleased to report to you that as of the date of this letter, our bank debt has been further materially reduced.

We are committed to ongoing concept and product development efforts, quality assurance and improved training programs. We recognize that while we may have resolved many of the problems that confronted us over the past two years we must be constantly vigilant in anticipating the needs and requirements of our customers. Of course, our basic objective is to provide our existing customers with a nutritious meal and friendly, courteous service in a clean restaurant and at a reasonable price. And it is in this way that we intend to retain and enhance our position as America's Number 1 steakhouse chain.

These past three years have been a time of adjustment, reorganization and planning. Much benefit has emerged from this process and we are confident that this experience will manifest itself positively this coming year. The loyalty and dedication of all of our employees has been exemplary and I am sure you join me in thanking them for this.

Sincerely,



Gerald S. Office, Jr.
Chairman of the Board
and President
April 27, 1977



- ESI Meats, Inc.
- Scotty's Locations
- Ponderosa Steakhouse Locations

Financial Highlights

	1977	1976	1975	1974	1973
Steakhouse Growth					
Company	342	322	300	226	148
Licensed	219	209	203	163	96
Revenues (\$000)	163,494	149,037	129,729	114,754	73,538
Net Income (\$000)	3,267	2,067	2,218	9,474	6,053
Net Income Per Share (\$)	0.73	0.46	0.50	2.13	1.39

Corporate Profile

The company consists of a chain of 342 company-operated and 219 licensee-operated Ponderosa Steakhouse restaurants located in 24 states and Canada with total combined revenues for fiscal 1977 of \$282,000,000. While primarily in the steakhouse business, the company also operates 10 Scotty's hamburger shops. The company has a wholly-owned meat processing subsidiary, ESI Meats, Inc., which owns and operates plants in Goshen, Indiana and Tampa, Florida. The Ponderosa steakhouse is a self-service style restaurant which seats approximately 200 customers and features a beef menu of 8 entrees and 3 seafood entrees ranging from \$.69 for a children's chopped beef sandwich with french fries to \$3.49 for a complete T-bone steak dinner. Dinners include a baked potato or french fries, tossed salad with a choice of dressing, a warm roll and butter. In addition to the entrees, the customer has a choice of beverages, desserts, and other related items including potato topping, hot buttered mush-

rooms and cottage cheese. The Ponderosa concept is simple and basic: to serve a quality steak dinner at a moderate price with fast, efficient and courteous service in a pleasant atmosphere.

Scotty's is a fast-food sandwich shop featuring a variety of sandwiches ranging in price from \$.30 to \$1.29.

ESI Meats, Inc. supplies all company-operated steakhouses and Scotty's restaurants with their beef requirements. In addition, ESI sells beef to many Ponderosa licensed steakhouses and makes certain sales to independent customers. Beef purchases by licensees are on a voluntary basis.

At the close of Fiscal 1977, Ponderosa had approximately 14,000 associates.

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Corporate Information

Ponderosa System, Inc.
P.O. Box 578, Dayton, Ohio 45401
Telephone (513) 890-6400

Annual Meeting—The Annual Meeting of Shareholders will be held at the Dayton Airport Inn, Terminal Road, James M. Cox Dayton International Airport, Dayton, Ohio at 9:00 AM on Thursday June 23, 1977.

The common stock of Ponderosa System, Inc. is traded on the New York Stock Exchange under the symbol PON.

The Steakhouse

The restaurant business is one of the world's most rapidly growing industries. Industry revenues for the top 100 chains increased over 21 per cent between 1970-1975, reaching approximately \$50.2 billion.

Contributing to this growth is a myriad of changing socio-economic conditions ranging from an increase in the number of working women, to more leisure time, to the coming of age of the nation's first "fast food generation"—the 18-34 age group.

Growth in Ponderosa's segment of the industry—family priced steak—has been even more pronounced, with sales rising on the average of 29 percent in each year between 1970 and 1975. The steak segment's sales figures for that period have more than tripled, jumping from \$.4 billion to \$1.3 billion.

With combined revenues of \$282 million last year, Ponderosa System, Inc., currently ranks as the nation's number one family priced steak retailer and the twelfth largest chain in the entire restaurant industry. Ponderosa's own rate of sales growth has stayed ahead of the steak segment, averaging approximately 31 percent per year since 1970.



The heart of Ponderosa, the steakhouse, deals primarily in beef entrees. Steak dinners on the menu include rib-eye, sirloin, chopped beef and T-bone. A selection of seafood entrees is also available including a shrimp dinner, filet-of-fish and a shrimp/rib-eye combination platter. Each dinner entree comes complete with potato, roll and salad from the all-you-can-eat salad bar. In addition, Ponderosa offers a delicious assortment of desserts and beverages.

Inside, the steakhouse can accommodate approximately 200 people. The self-service style format allows Ponderosa to serve 300 people every hour—and serve them efficiently and courteously. That concentration on quality service—coupled with quality products—enabled Ponderosa to serve more than 100 million customers in fiscal 1977.

Serving the customers are more than 21,000 associates. Many steakhouse associates are students and others working for the first time, gaining that measure of responsibility and experience that comes with a first job.





The heart of the Ponderosa system, the steakhouse, provides its customers with a complete, nutritious dinner, from a variety of entrees, in pleasant, clean surroundings—the "Square Meal-Square Deal."

Heading each steakhouse is a team of professional managers, responsible for the entire operation of the restaurant. The management team is Ponderosa's front line in a system-wide effort to provide customers with excellent food and service in a clean, attractive environment.

To carry that same quality through its entire corporate structure, Ponderosa has developed an efficient supervision network to assure effective communication between the steakhouse and the corporation. Every seven to ten restaurants in a locale are responsible to an area supervisor who has worked up through the levels of steakhouse management. Five to seven area supervisors report to a district manager who, in turn, reports to one of two Executive Vice Presidents at Ponderosa's Dayton headquarters.

Regardless of whether an associate is a young student or an experienced manager, the goal is the same: to provide families with a moderately priced, but nutritious, dinner in a pleasant atmosphere—the "Square Meal-Square Deal". And Ponderosa's people continue to work to make both the "meal" and the "deal" more appealing.

Licensing

Included among the steakhouses that make up the Ponderosa system are 219 restaurants operated by independent owners called licensees. As an independent businessman, the Ponderosa licensee either operates a single steakhouse in his city or owns the licenses to a number of restaurants in an area.

Each year licensee fees contribute substantially to the corporation's revenues, totaling nearly \$3 million in fiscal 1977. The Ponderosa licensee also brings with him his own unique skills and experience, plus an in-depth understanding of his community and its people. That knowledge, coupled with some fresh ideas, provide the entire Ponderosa network with a wider range of skills and a broader viewpoint of steakhouse operations.

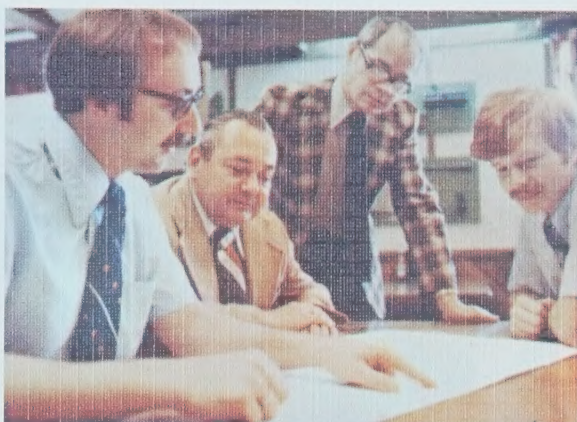
In return for his contributions, the licensee receives the same corporate back-up—and provides the same "Square Meal-Square Deal" for his customers—as the company-operated steakhouses. (A more complete look at the support system each restaurant receives is in the next section of this report). Actually, a customer entering a Ponderosa steakhouse sees no difference between a licensed and company-operated restaurant—because there is none.



Ponderosa has a specially trained licensing staff available to aid in site selection, construction and operation of the licensee steakhouses. The special staff ranges from field members who work with the potential licensees from the first stages of planning, to consultants who regularly meet with the licensee steakhouse management after the restaurant has opened.

Once the license has been granted, the staff can aid in obtaining both a site and the financing for the restaurant. Whether the company or the licensee himself locates the site, Ponderosa's staff makes a complete market study of the location, including a detailed demographic breakdown of the area surrounding the proposed steakhouse.





Every Ponderosa licensee is an integral part of both his steakhouse and his community. A typical day finds the licensee interacting with local civic associations, working with his banker, helping prepare an ad layout for the newspaper and, of course, overseeing the operations at his restaurant. Company hosted seminars provide up-to-date information on the restaurant industry and steakhouse operations.

During the construction of the restaurant, Ponderosa provides a construction supervisor who makes sure the building meets the company's specifications and who makes regular visits to the site to assess the building's progress. Also during the construction phase, the licensee—and his management personnel—come to Dayton to complete a formal classroom training program to prepare them for steakhouse operations.

Finally, before the doors of the licensee steakhouse are opened for business, the company provides a field consultant who aids the owner in such activities as obtaining proper staffing, training of associates, and working with national, regional and local suppliers. The consultant will then remain in the steakhouse during its initial opening period to assure a smooth beginning of operations.

Ponderosa and its licensees maintain an active and free flowing level of communication. The company holds both general seminars and special topic workshops for licensees four times each year. These seminars not only give Ponderosa's staff the opportunity to provide the licensee with up-to-date information but, equally important, provide a forum for a positive interchange of ideas. In addition, periodic workshops are held which focus on particular aspects of the business and solutions to common problems. Many licensees participate in testing programs along with company-operated units. A number of the beneficial changes that Ponderosa has made in the past years have been the direct result of contributions made by its licensees.

Company Support

From its modern national headquarters in Dayton, Ohio, Ponderosa provides its steakhouses—both licensed and company-operated—with a wide variety of support systems. The basic support ingredient given each steakhouse is professional people. More than 200 corporate staff members provide a full range of talents and experience to complement the thousands of associates in the field.

Among the corporate staff groups is the Training Department which provides field management personnel with the operational training and management orientation required to serve our customers an excellent meal with responsive service in pleasant surroundings.

It begins with placement in one of approximately 35 designated training restaurants, working and learning for five weeks under an experienced "teaching" Executive Manager. Then, after completion of a prescribed set of learning objectives, the newly certified Assistant Manager is given an on-the-job opportunity to apply the skills for three months prior to attending a comprehensive eleven-day classroom program at Ponderosa's Training Center in Dayton, Ohio. Upon graduation, the associate is qualified to become a Manager of a steakhouse. Special seminars are available to train Managers for promotion to Executive Manager and in addition, special seminars are available to further develop the managerial effectiveness of experienced Executive Managers.

To accommodate the ever-changing needs and desires of our customers and to insure the maintenance of the quality of present products is the responsibility of the Corporate Development Department. No product, whether it's steak or the mushrooms used in a sauce, is ever served a customer without first being subjected to stringent testing by this group. To examine the feasibility of offering any new menu item and to keep assuring the quality of existing entrees the department maintains a

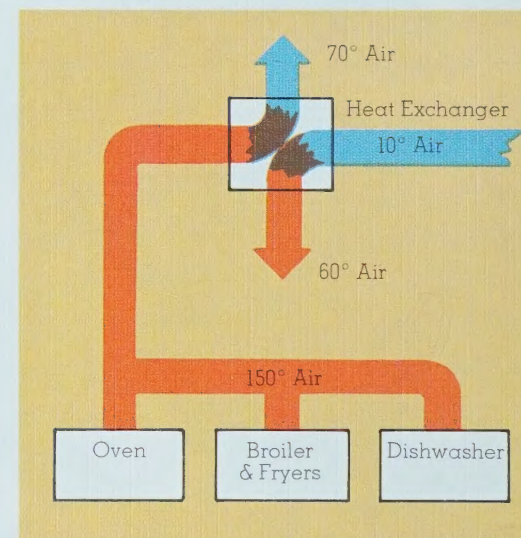
fully equipped test kitchen in Dayton.

This department is also responsible for long-range planning and new motifs for steakhouses. One of its most recent projects in this function was last year's program that resulted in a new steakhouse format including a more comfortable seating atmosphere as well as new associate uniforms and exterior sign design.

The Marketing Department efforts are directed toward attracting customers through effective advertising and research. To accomplish this, the system last year spent \$7.4 million to purchase radio and television time and print media advertising space.

Highlighting that effort is Ponderosa's successful advertising theme—"Square Meal-Square Deal", a theme that has not only increased the public's awareness of Ponderosa, but also serves as an accurate portrayal of our product offering. Research shows that company-sponsored television ads have a viewer recall percentage running nearly 50 percent higher than the average for the fast food industry.

Years before the energy shortage became critical, Ponderosa's Construction Department initiated a conservation program that today includes a system of heat exchange devices that extract exhaust air from the cooking areas. Each restaurant using the system can capture up to





Ponderosa offers all its steak houses- company-owned and licensed -with a total support package ranging from management training to advertising and marketing to energy conservation to purchasing to food testing

70 percent of the heat contained in the exhausted air and return it to heat the building's interior, eliminating the need for a 400,000 BTU heater. Other segments of the energy program include a "black box" that automatically turns on and off all electrical appliances in the restaurant. A special data processing program in corporate headquarters serves as a "report card" for monitoring each company steakhouse's energy efficiency

Perhaps one of Ponderosa's most cost effective efforts comes from its extensive purchasing operations. Last year, for example, 6,000,000 pounds of French fries, 936,000 pies, 575,000 gallons of salad dressings, 500,000 gallons of soft drinks, 22,000 cases of ketchup, and 900,000 pounds of coffee, were purchased for company units through competitive negotiation and supplied by order against these national contracts. Thus, Ponderosa is able to creatively purchase food products and supplies at the most advantageous price and to high quality specifications

ESI Meats, Inc.

The quality that goes into Ponderosa's steaks begins in the modern meat processing plants of its wholly-owned subsidiary, ESI Meats, Inc. which operates facilities in Goshen, Indiana and Tampa, Florida. From those modern plants, more than 30,000,000 pounds of meat are distributed each year to steakhouses by a fleet of refrigerated trucks that operate 365 days a year. In addition, acting as a commissary, ESI distributes approximately 10,000,000 pounds of related food items per year.

Scotty's Hamburgers System, Inc.

Scotty's is a chain of 10 fast food sandwich shops operating in Indiana and Kentucky with the same business philosophy and management controls as the steakhouses. But the chain offers more than just hamburgers. Its sandwich menu line includes steak, ham and cheese, roast beef, tenderloin, submarines and hot dogs.

Statements of Consolidated Income and Retained Earnings

	Year Ended	
	February 24 1977	February 26 1976
Food sales	\$159,470,429	\$145,298,725
Service fees and other income	<u>4,023,750</u>	<u>3,738,261</u>
	163,494,179	149,036,986
Costs and expenses—Note E:		
Cost of food sales	74,314,632	68,210,041
Restaurant operating expenses	65,175,206	55,673,370
Rent expense	11,103,859	10,267,688
General and administrative expenses	6,152,545	6,125,687
Interest expense (primarily on long-term debt) and amortization of debt discount and issue expense	1,517,747	1,618,659
Deferred advertising and training write-off—Note F	<u>-0-</u>	<u>3,550,000</u>
	158,263,989	145,445,445
INCOME BEFORE INCOME TAXES	5,230,190	3,591,541
Income taxes:		
State	250,000	240,000
Federal:		
Current	1,363,300	1,929,000
Deferred	<u>350,000</u>	<u>(644,000)</u>
	1,963,300	1,525,000
NET INCOME	<u>\$ 3,266,890</u>	<u>\$ 2,066,541</u>
Net income per share	<u>\$0.73</u>	<u>\$0.46</u>
Retained earnings at beginning of year	\$ 26,215,337	\$ 24,148,796
Net income for the year	<u>3,266,890</u>	<u>2,066,541</u>
RETAINED EARNINGS AT END OF YEAR	<u>\$ 29,482,227</u>	<u>\$ 26,215,337</u>

See notes to consolidated financial statements

Statement of Changes in Consolidated Financial Position

	Year Ended	
	February 24 1977	February 26 1976
FUNDS PROVIDED		
From operations:		
Net income	\$ 3,266,890	\$ 2,066,541
Expenses not requiring current outlay of working capital:		
Depreciation	5,309,437	4,493,310
Amortization	193,641	193,641
Increase in noncurrent deferred federal income taxes	276,834	570,682
FUNDS PROVIDED FROM OPERATIONS	9,046,802	7,324,174
Carrying value of property, plant and equipment disposals	677,291	220,602
Long-term borrowings	14,500,000	5,600,000
Capitalization of lease obligation	1,167,060	-0-
Decrease in other assets	21,213	1,120,663
	25,412,366	14,265,439
FUNDS USED		
Property, plant and equipment purchased during the year	11,482,255	7,623,823
Payments on and current maturities of long-term debt	20,828,067	4,858,114
	32,310,322	12,481,937
(DECREASE) INCREASE IN WORKING CAPITAL	\$ (6,897,956)	\$ 1,783,502
(DECREASES) INCREASES IN WORKING CAPITAL:		
Cash and short-term investments	\$ (9,433,418)	\$ 9,566,231
Recoverable federal income taxes arising from overpayment of estimates	-0-	(2,097,716)
Accounts receivable	226,850	(493,006)
Inventories	1,454,093	(1,403,999)
Prepaid expenses	79,168	(3,889,011)
Accounts payable and accrued expenses	(208,573)	(424,633)
Federal income taxes	1,909,792	(1,918,882)
Deferred federal income taxes	-0-	1,273,050
Current portion of long-term debt	(925,868)	1,171,468
(DECREASE) INCREASE IN WORKING CAPITAL	\$ (6,897,956)	\$ 1,783,502

See notes to consolidated financial statements

Consolidated Balance Sheet

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	February 24 1977	February 26 1976
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 6,665,533	\$ 6,395,387
Accrued expenses	2,229,187	2,290,760
Federal income taxes	9,090	1,918,882
Current portion of long-term debt	<u>1,169,400</u>	<u>243,532</u>
TOTAL CURRENT LIABILITIES	10,073,210	10,848,561
SENIOR LONG-TERM DEBT —less portion classi- fied as current liabilities—Note B		
Installment notes payable	208,729	264,105
Note payable to bank	11,500,000	16,500,000
Capitalized lease obligations	<u>1,908,369</u>	<u>1,300,000</u>
	13,617,098	18,064,105
5% SUBORDINATED DEBENTURES DUE DECEMBER 1, 1983 , less unamortized debt discount (1977—\$221,550; 1976—\$292,150) and portion classified as current liabilities—Note B	4,064,450	4,707,850
DEFERRED FEDERAL INCOME TAXES	4,117,864	3,841,030
STOCKHOLDERS' EQUITY —Notes B and C		
Common Stock, par value \$0.10 per share:		
Authorized 25,000,000 shares		
Issued 4,757,475 shares	475,747	475,747
Capital surplus	8,950,693	8,950,693
Retained earnings	<u>29,482,227</u>	<u>26,215,337</u>
	38,908,667	35,641,777
Less cost of 281,968 shares in treasury	<u>355,430</u>	<u>355,430</u>
	38,553,237	35,286,347
LEASES —Note D	<u>\$70,425,859</u>	<u>\$72,747,893</u>

See notes to consolidated financial statements

Notes to Consolidated Financial Statements

NOTE A—ACCOUNTING POLICIES

Basis of Consolidation:

The consolidated financial statements include the company and all of its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Short-Term Investments:

Short-term investments are stated at cost which approximate market.

Inventories:

Inventories are stated at the lower of cost or market on the first-in, first-out method.

Property, Plant and Equipment:

Property, plant and equipment are carried at cost and include expenditures for new facilities, costs of obtaining leaseholds and significant betterments to existing facilities. Maintenance, repairs and minor renewals are charged directly to expense as incurred.

The cost of assets retired or otherwise disposed of, together with the accumulated depreciation thereon, are relieved from the appropriate asset and accumulated depreciation accounts. Any gain or loss resulting from these transactions is reflected in net income.

Depreciation:

Depreciation is computed on the straight-line method over periods designed to amortize the cost of the assets over their estimated useful lives. The general ranges of depreciation rates used are as follows: Buildings, 2–4%; Leaseholds, 5–7%; Equipment, 10–13%; Improvements, 5–10%.

Excess of Cost Over Market Value of Related Net Assets of Businesses Purchased:

The excess of cost over market value of related net assets of businesses purchased arising prior to November 1, 1970, amounts to \$1,618,702. This amount arose primarily with the acquisition of Scotty's Hamburgers System, Inc., and in the opinion of management, these investments have appreciated in value and, accordingly, no amortization is being provided. The remaining excess cost over market value of related net assets of businesses purchased arising after October 31, 1970, is being amortized over periods ranging from 10 to 17 years.

Income Taxes:

Taxes are provided for all items included in the statement of income, regardless of the period when such items are reported for tax purposes. The company follows the practice of providing for deferred taxes for differences in the timing of deductions for financial accounting purposes and income tax purposes. The timing differences principally result from using accelerated methods of depreciation for income tax purposes.

Investment credit is accounted for on the flow-through method and amounted to approximately \$671,000 in 1977 and \$328,000 in 1976.

Stock Options:

Upon exercise of stock options, an amount equal to the par value of Common Stock (\$0.10) is credited to Common Stock for each share issued and the balance of the proceeds is credited to capital surplus. No amounts are charged to income in connection with the Plans.

Net Income Per Share:

Net income per share is computed on a weighted average of shares of Common Stock outstanding during each year. Exercise of stock options, which are Common Stock equivalents, would cause no significant dilution.

NOTE B—LONG-TERM DEBT

The installment notes payable are payable to banks and individuals in varying installments to 1988 and are substantially secured by mortgages on certain property and equipment. The notes bear interest at rates from 7% to 9%.

The note payable to bank at February 24, 1977, is under a \$14,500,000 revolving credit agreement expiring July 1, 1979. The note bears interest at prime plus $\frac{1}{2}\%$. In addition, the agreement requires a commitment fee of $\frac{1}{2}\%$ computed quarterly in arrears on the unused portion of the line of credit. At July 1, 1979, the amount borrowed under the agreement will convert to a four year term loan, payable in equal quarterly installments through June 30, 1983, with interest at prime plus $\frac{3}{4}\%$. The agreement contains, among other things, requirements to be met as to working capital, current ratio, payment of cash dividends, other debt and stockholders' equity. The note payable to bank at February 26, 1976, was refinanced during the year.

The capitalized lease obligations are in connection with leases on the corporate office building and data processing equipment which are considered purchase agreements for both accounting and tax purposes. The building is being depreciated over 50 years. The office building is partially financed through \$2,000,000 of Industrial Development Revenue Bonds issued by the County of Montgomery, Ohio. The bonds are secured by the lease on the building which requires the company to

pay rentals equal to the principal and interest on the bonds plus related expenses. Annual principal payments range from \$190,000 to \$240,000 through 1982 plus interest at 5% on the unpaid balance. The company must purchase the building for \$100 at the expiration of the lease. The data processing equipment is being depreciated over 8 years. The company can purchase the data processing equipment for \$116,700 at the end of 5 years.

The debentures are subordinated to all outstanding or subsequently incurred senior indebtedness. The debentures are redeemable at the option of the company in whole or in part at redemption prices ranging from 102 $\frac{1}{4}\%$ currently to 100% beginning December 1, 1982. The Indenture provides for a sinking fund for the redemption of one-seventh annually of debentures outstanding beginning December 1, 1977. The Indenture also places a restriction on the amount of cash dividends which may be paid.

Under the most restrictive covenant in the above debt agreements, \$28,200,000 of retained earnings are restricted and not available for payment of dividends at February 24, 1977.

Annual principal payments on long-term debt required during the next five years approximate: 1978—\$1,169,000; 1979—\$1,181,000; 1980—\$2,653,000; 1981—\$4,127,000; 1982—\$3,916,000.

NOTE C—STOCK OPTIONS

The company adopted a qualified stock option plan on August 22, 1968 (old plan). Under the plan, key employees were granted options at the discretion of the Stock Option Committee of the Board of Directors, at prices not less than 100% of the fair market value at the date the option was granted. Each option granted is exercisable in three annual installments on the first and each succeeding anniversary of the date of grant, each installment comprising one-third of the total shares subject to the option. No option is exercisable while any option previously granted to the same individual at a greater exercise price is outstanding. All options terminate not later than five years from the date of grant and must be exercised, with certain exceptions, while the holder is in the employ of the company. No further options may be granted under this plan.

On June 16, 1972, the company adopted a new qualified stock option plan (new plan) which is similar to the old plan except for conditions regarding the employment of individuals holding options and the timing of their right to exercise their options.

The company has reserved 25,500 shares of Common Stock under the old plan and 200,000 shares of Common Stock under the new plan.

The following summarizes the options for the two years ended February 24, 1977:

	Number of Shares	Option Price Per Share
February 24, 1977:		
Options outstanding	146,800	\$ 6.125 to \$81.8125
Options exercisable	108,829	7.25 to 81.8125
Options exercised	-0-	-0-
February 26, 1976:		
Options outstanding	187,115	\$ 7.25 to \$81.8125
Options exercisable	101,617	\$11.34375 to 81.8125
Options exercised	-0-	-0-

NOTE D—LEASES

Rent expense for all leases amounted to:

	February 24 1977	February 26 1976
Financing Leases:		
Minimum	\$10,378,515	\$ 9,466,220
Contingent	174,670	160,637
Other leases	550,674	640,831
	11,103,859	10,267,688
Less sublease income	707,676	660,786
	<u>\$10,396,183</u>	<u>\$ 9,606,902</u>

The contingent rentals arose when sales exceeded specified amounts. Some leases contain options to renew the lease for two separate five-year periods.

The future minimum rental commitments on all non-cancelable leases as of February 24, 1977 are approximately as follows:

	Total Lease Commitment	Total Subleases	Net Lease Commitment
1978	\$10,974,000	\$ 543,000	\$10,431,000
1979	10,949,000	543,000	10,406,000
1980	10,880,000	543,000	10,337,000
1981	10,861,000	543,000	10,318,000
1982	10,828,000	543,000	10,285,000
1983-1987	52,607,000	2,593,000	50,014,000
1988-1992	47,919,000	1,636,000	46,283,000
1993-1997	21,199,000	170,000	21,029,000
1998 and subsequent	3,356,000	5,000	3,351,000

NOTE D—LEASES (continued)

The estimated net present values of the fixed minimum rental commitments for noncancelable financing leases are summarized below assuming interest rates ranging from 5.75% to 14.75%. Substantially all of these leases are for real property.

	February 24 1977	February 26 1976
Total present values	\$91,525,000	\$83,188,000
Less present values of sublease rentals	4,422,000	4,285,000
Net present values	\$87,103,000	\$78,903,000

The impact on net income if the financing leases had been capitalized would have been to reduce net income by approximately \$1,396,000 and \$1,122,000 for fiscal years 1977 and 1976, respectively. This computation assumes that the estimated present values were amortized on a straight-line basis over the terms of the leases and that interest expense was accrued on the outstanding lease obligations. The approximate amounts included in the computation for interest expense and amortization of property rights were respectively \$7,703,000 and \$4,695,000 in 1977 and \$6,874,000 and \$4,078,000 in 1976.

The company is not acquiring any equity interest in the properties represented by these leases and does not have options to purchase the properties for less than fair market value.

NOTE E—RECLASSIFICATION OF COSTS AND EXPENSES

Certain costs and expenses for the year ended February 26, 1976, have been reclassified to make the amounts comparable with the current year.

NOTE F—CHANGE IN ACCOUNTING METHOD

Effective February 26, 1976, the company changed its method of accounting for the costs of training steak-house managers and for the costs of advertising in expansion markets. These costs, which had previously been deferred and amortized over two years or less, are now expensed as incurred. This change reflects the adoption by the company of a more conservative accounting policy which results in a better matching of current revenues and expenses.

The change is considered to be a change in accounting principle inseparable from a change in accounting estimate and, as such, results in a charge to income of the amount of costs deferred as of the date of change. Deferred training and advertising costs amounted to \$3,550,000 at February 26, 1976, as indicated in the caption "Deferred advertising and training write-off" in the Statement of Consolidated Income. This amounts to \$1,846,000 after tax or \$0.41 per share.

NOTE G—SUMMARY OF QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following is a summary of unaudited quarterly results of operations for the year ended February 24, 1977:

	Quarter Ended			
	May 20	August 12	November 4	February 24
	(Thousands of dollars, except per share data)			
Food sales	\$37,521	\$38,335	\$37,039	\$46,575
Gross profit	2,959	2,695	807	2,416
Net income	•1,334	1,067	100	766
Net income per share	.30	.24	.02	.17

Report of Ernst & Ernst Independent Auditors

Board of Directors
Ponderosa System, Inc.
Dayton, Ohio

We have examined the consolidated balance sheet of Ponderosa System, Inc. and Subsidiaries as of February 24, 1977, and February 26, 1976, and the related consolidated statements of income, retained earnings and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Ponderosa System, Inc. and Subsidiaries at February 24, 1977, and February 26, 1976, and the consolidated results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in the method of accounting for certain deferred charges as described in Note F to the consolidated financial statements.

Dayton, Ohio
April 8, 1977



Financial Review

MARKET INFORMATION

The Common Shares of the company are listed on the New York Stock Exchange. The company does not pay a dividend. The high and low sales prices for shares traded on the New York Stock Exchange for the past two fiscal years were as follows:

SALES PRICE OF COMMON SHARES

Fiscal Quarter	Fiscal 1977		Fiscal 1976	
	High	Low	High	Low
First	12¾	9¼	12¼	7½
Second	10%	8	13¼	8%
Third	8%	6	11½	8%
Fourth	7%	6	14	8½

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE SUMMARY OF OPERATIONS

Fiscal 1977 compared with Fiscal 1976

Consolidated revenues of \$163.5 million were \$14.5 million or 10% above the preceding year. Steakhouse sales increased 10% primarily because of a 6% increase in the average number of steakhouses in operation. Per unit steakhouse volume increased by 4%. The average check increased from \$2.06 to \$2.33 due to price increases, a new line of desserts and the introduction of salad bars.

Service fees and other income increased \$0.3 million or 8% in fiscal 1977. Within that category, service fees increased 10% and rental income increased 3% due to additional licensed unit volume.

Cost of food sales increased \$6.1 million or 9% in fiscal 1977. Purchasing efficiencies, menu price increases and operating efficiencies achieved at the ESI meat plants resulting from the cost control efforts of management were the primary reasons cost of food as a percentage of food sales remained at 47% as experienced in fiscal 1976.

Restaurant operating expenses increased \$9.5 million or 17% over the preceding year primarily due to a 6% increase in the average number of steakhouses in operation and higher labor costs due to minimum wage increases and increased utility costs incurred resulting from extreme weather conditions experienced and generally higher fuel costs.

Offsetting the above increases, was a decrease in advertising expense of \$2.9 million. Of the \$2.9 million decrease, \$1.8 million was attributable to the amortization of prepaid advertising during fiscal 1976 which was not incurred in fiscal 1977 due to a change in the accounting method for advertising costs as described in Note F to the consolidated financial statements. The remaining \$1.1 million decrease in advertising expense resulted from a decrease in spending on media advertising.

Rent expense increased \$0.8 million or 8% in fiscal 1977. This increase was due to the increased number of steakhouses and the higher rentals on new units.

Interest expense and amortization of debt discount and issue expense declined by \$0.1 million or 6% because of lower average borrowings and interest rates during fiscal 1977.

In fiscal 1977 an aggregate increase of \$1.7 million was incurred in payroll taxes, real estate taxes, maintenance and repair expenses, and depreciation expense. These increases were attributable to more employees, higher federal and state tax wage bases, and additional units in operation.

Consolidated income taxes increased \$0.4 million in fiscal 1977. The consolidated effective tax rate in fiscal 1977 was 38% compared with 42% in fiscal 1976. The decrease was attributable to higher state income taxes in some states being offset by a higher investment tax credit in fiscal 1977. The investment tax credit in fiscal 1977 was \$0.7 million compared to \$0.3 million in fiscal 1976.

Fiscal 1976 compared with Fiscal 1975

Consolidated revenues of \$149.0 million were \$19.3 million or 15% above revenues for the preceding year. Steakhouse sales increased 19% primarily because of a 20% increase in the average number of steakhouses in operation. Per unit steakhouse volume declined by 0.8%. The average check increased from \$1.97 to \$2.06 due to price increases and line of desserts introduced late in the year. Sales by Scotty's hamburger shops declined by 20% due to economic and competitive factors and because one unit was closed during the year. ESI meat plant sales to licensees and third parties decreased by 24% due to lower meat prices and lower sales to licensees, offset by higher sales to third parties.

Service Fees and Other Income increased \$0.3 million or 8% in fiscal 1976. Within that category, service fees increased 15% and rental income increased 6% due to additional licensed unit volume.

Cost of Food Sales increased \$2.1 million in fiscal 1976. Cost of food as a percentage of food sales improved from 52% in fiscal 1975 to 47% in fiscal 1976. Lower meat and food prices, purchasing efficiencies, and menu price increases were the primary reasons for the improvement.

Restaurant Operating Expenses increased \$11.6 million or 26% over the preceding year. Within that category, steakhouse operating expenses increased 23% primarily due to a 20% increase in the average number of steakhouses in operation. The second largest increase within the Restaurant Operating Expense category was advertising which increased from \$3.5 million in fiscal 1975 to \$6.2 million in fiscal 1976, an increase of 77%. This increase was due to the utilization of a stronger and more competitive marketing effort to increase customer awareness of existing and newly introduced products.

Rent expense increased \$1.8 million or 22% in fiscal 1976. This increase was due to the increased number of steakhouses and the higher rentals on new units.

Interest Expense and Amortization of Debt Discount and Issue Expense declined by \$0.5 million or 24% because of lower average borrowings and interest rates during fiscal 1976.

In February of 1976, the company announced a change in the accounting method for training and advertising costs effective as of the end of fiscal 1976. This change resulted in a non-recurring non-cash charge to pre-tax income of \$3.5 million as described in Note F to the consolidated financial statements. In fiscal 1976 an aggregate increase of \$2.4 million was incurred in payroll taxes, real estate taxes, maintenance and repairs, and depreciation expense. These increases were attributable to more employees, increases in appraised values of existing units and additional units in operation.

Consolidated income taxes increased \$0.2 million in 1976. The consolidated effective tax rate in fiscal 1976 was 42% compared with 38% in fiscal 1975. The increase is attributable to higher state income taxes in some states and a lower investment tax credit in 1976. The investment tax credit in 1976 was \$0.3 million compared to \$0.4 million in 1975.

Five Year Financial Data*

(Financial data in thousands except for per share figures)

	Fiscal Year Ended				
	2/24/77	2/26/76	2/27/75	2/28/74	2/23/73
Revenues					
Food sales	\$159,470	\$145,299	\$126,274	\$110,787	\$69,793
Service fees and other income	4,024	3,738	3,455	3,967	3,745
Total Revenues	163,494	149,037	129,729	114,754	73,538
Costs and Expenses					
Costs of food sales	74,315	68,210	66,132	56,831	35,244
Restaurant operating expenses	65,175	55,673	44,071	30,678	20,509
Rent expense	11,104	10,268	8,433	5,724	3,502
General and administrative expenses	6,152	6,126	5,370	3,729	2,585
Interest (primarily on long-term debt) and amortization of debt discount and issue expense.	1,518	1,618	2,132	582	509
Deferred advertising and training write-off	—	3,550	—	—	—
Total Costs and Expenses	158,264	145,445	126,138	97,544	62,349
Income Before Income Taxes	\$ 5,230	\$ 3,592	\$ 3,591	\$ 17,210	\$11,189
Net Income	\$ 3,267	\$ 2,067	\$ 2,218	\$ 9,474	\$ 6,053
Net Income Per Share	\$.73	\$.46	\$.50	\$ 2.13	\$ 1.39
Total Assets	\$ 70,426	\$ 72,748	\$ 69,399	\$ 67,129	\$38,363
Long Term Debt	\$ 17,682	\$ 22,772	\$ 21,959	\$ 20,469	\$ 8,463
Stockholders' Equity	\$ 38,553	\$ 35,286	\$ 33,220	\$ 30,863	\$20,744
Stockholders' Equity Per Share	\$ 8.61	\$ 7.88	\$ 7.42	\$ 6.93	\$ 4.75
Property, Plant and Equipment Additions	\$ 11,482	\$ 7,624	\$ 14,649	\$ 16,511	\$ 7,491

*All financial data have been re-stated to reflect the acquisition of two companies on a pooling of interests basis in June, 1972 and one company on a pooling of interests basis in February, 1973. All per share data have been adjusted for the 2-for-1 stock split in March, 1972.

Officers

Gerald S. Office, Jr.
Chairman of the Board of Directors
and President

Donald D. Darbyshire
Executive Vice-President
(Operations)

Richard T. Good
Executive Vice-President
(Marketing and Unit Development)

John A. Scott
Executive Vice-President
(Administration)

Edwin S. Weber, Jr.
Executive Vice-President
(Operations)

Robert F. Wolf
Executive Vice-President
(President-ESI Meats, Inc.)

Craig M. Campbell
Vice President
(Licensing) and Secretary

C. S. Lewis
Vice President
(Corporate Development)

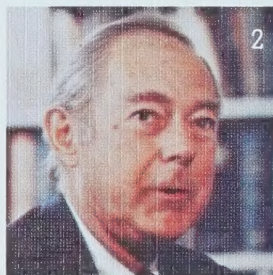
Robert H. Earp, Jr.
Vice President
(Operations)

Robert J. Nugent, Jr.
Vice President
(Operations)

Kenneth J. Palmer
Vice President
(Marketing Services)

Chester A. Grabowski
Treasurer

Kenneth R. Dobbel
Controller



1. Richard T. Good, C. S. Lewis
2. Richard G. Brierley
3. Gerald S. Office, Jr.
4. Craig M. Campbell, Donald D. Darbyshire, Edwin S. Weber, Jr.
5. Robert F. Wolf, John A. Scott
6. Kenneth J. Palmer, Robert H. Earp, Jr., Robert J. Nugent, Jr.
7. Fred G. Wall
8. John L. Schaefer
9. John F. Torley
10. Chester A. Grabowski, Kenneth R. Dobbel
11. W. H. (Bill) Williams

Directors



Gerald S. Office, Jr.
Chairman of the Board of Directors
and President
Ponderosa System, Inc.

Richard G. Brierley
Director, Consultant and Former
Chairman of the Board of Directors
The Stearns and Foster Company
(Manufacturer of home furnishings
and non-woven textiles) Cincinnati,
Ohio

John L. Schaefer
Director, Chairman of the Board and
President
The Specialty Papers Co., (Manufac-
turer of flexible packaging
materials), Dayton, Ohio

John F. Torley
Director, Chairman of the Board and
Chief Executive Officer
Dayton Malleable Inc.
(Manufacturer of metal castings),
Dayton, Ohio

Fred G. Wall
Director, President and Chief Execu-
tive Officer, Robbins & Myers, Inc.
(Manufacturer of pumps, cranes,
hoists, motors and ventilating and
heating equipment), Springfield,
Ohio

W. H. (Bill) Williams
Director, Vice-President—Materials
Management, Eaton Corporation
(Manufacturer of engineered prod-
ucts for capital goods, automotive,
truck and consumer markets,)
Cleveland, Ohio

10-K Information

The company will furnish to any shareholder without charge a copy of the company's annual report filed with the Securities and Exchange Commission on Form 10-K for the 1977 fiscal year (including the financial statements and schedules thereto) upon written request from the shareholder addressed to—Treasurer, Ponderosa System, Inc., P.O. Box 578, Dayton, Ohio 45401.

Equal Employment Opportunity Statement

Ponderosa System, Inc., is committed to the full and effective utilization of qualified associates regardless of sex, age, race, color, religion, or ethnic origin. Our Equal Employment Opportunity Affirmative Action Plan is a process designed to work toward the elimination of discrimination by breaking down barriers of habit, attitudes and practices which prevent the recognition of individual qualifications, potential, and merit. We have and will continue to vigorously cultivate a climate in this direction.

Auditors

Ernst & Ernst, Dayton, Ohio

Legal Counsel

Coolidge, Wall, Matusoff, Womsley & Lombard Co., L.P.A., Dayton, Ohio

Registrars

Winters National Bank & Trust Co., Dayton, Ohio,
Chemical Bank, New York, New York

Transfer Agents

Winters National Bank & Trust Co., Dayton, Ohio,
Chemical Bank, New York, New York

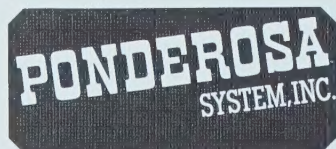
Trustee

The Bank of New York,
New York, New York

Corporate Headquarters

James M. Cox Dayton International Airport
P.O. Box 578
Dayton, Ohio 45401
Telephone (513) 890-6400

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Ponderosa System, Inc.
P.O. Box 578, Dayton, Ohio 45401